MISSOURI BUDGET PROJECT

HIGHLIGHTS OF MISSOURI BUDGET & TAX POLICY

Missouri's Budget Situation

- Missouri faces increasingly difficult decisions each year to balance the state budget and struggles to provide adequate funding for the public services that provide the foundation upon which families, communities and our economy can thrive, such as education, public health & safety and transportation.
- In the current year, lawmakers are debating cuts to health care services for seniors and people with disabilities versus cuts to the circuit breaker property tax credit – a modest tax credit that helps seniors and people with disabilities who have fixed incomes to remain in their homes.
- Over the last decade Missouri has already significantly diminished investments in education, child care, health care and other services; and the state now ranks well below most other states in nearly every indicator.
- But, it doesn't have to be this way. School children, seniors, Missourians with disabilities and working families did not create Missouri's budget struggles – faulty tax policy did.
- We can revise the tax policies that do not generate economic growth so that we can invest in our greatest asset – our people.

Examples of Reduced Services

K-12 Education:

- The Foundation Formula is the mechanism used to distribute state funding to local schools. Since 2010 the state has not fully funded the statutorily required funding levels under the formula.
- As a result, the burden for funding local schools is increasingly shifting to localities, resulting in increasing a troubling disparity in education funding among school districts.
- In the 2013-2014 school year, the combined per student revenue available varied significantly among school districts – from a low of $8,968 in St. Francois County to a high of $15,778 in St. Louis County.

Early Education & Child Care:

- Studies show that children who receive quality early education do better in school, have higher incomes and improved health outcomes as adults compared to their peers.
- Studies also indicate that public investments in preschool and other early learning initiatives provide a significant return to taxpayers, resulting in as much as a $7 return for every $1 invested due to decreased public expense for remedial education, criminal justice and social services.
- But, Missouri's investment in early care and education is well below other states

- Eligibility for child care assistance ends at just 138% of the federal poverty level, well below the national average of 178% FPL and below most of our neighboring states.
- Only a very small number of Missouri children currently receive state-funded preschool. In 2014, just 2 percent of 3-year olds and 3 percent of 4-year olds, combined just 3,874 children, in Missouri were served. In that same year, Missouri provided just $2,009 in funding per child enrolled.

Higher Education:

- Funding for state colleges and universities has also declined over the last decade.
- Comparing the 2006 school year and the 2016 school year, the amount of state funding per student in Missouri's 4-year public colleges has dropped by $600 (not adjusted for inflation).
- Further, lawmakers are currently considering additional and significant cuts to higher education for the FY 2018 budget

Public Health Services:

- Although Medicaid was created to serve as a safety net for low wage families and individuals, not all Missourians living in poverty qualify.
- Missouri's eligibility level for MO HealthNet for working parents is among the most restrictive in the nation. Working parents can earn no more than $385 per month for a family of three, the equivalent of 22% of the federal poverty level (FPL).
- In fact, Missouri's eligibility level for parents is third lowest in the nation- surpassing only Alabama and Texas – and well below the national average of 138% FPL.
- Seniors and people with disabilities can qualify with incomes up to 85% FPL; pregnant women qualify with incomes up to 185% FPL for the period during their pregnancy and 6 weeks of postnatal care; and children qualify for Medicaid or CHIP up to 300% FPL.
- Low wage adults without children do not qualify for assistance in Missouri.

<u>How We Got Here</u>

The Hancock Amendment

- Missouri's budget struggles are not a short term problem.
- The problems can be traced back to the Hancock Amendment. Passed by voters in 1980, the Hancock Amendment is a constitutional restriction that limits the growth in state revenue to the ratio of personal income that it made up at that time.
- Missouri did not hit the Hancock lid until the late 1990s when economic growth was really strong.
- Between 1995-2000 the state reached the Hancock lid every year, and was required to refund to taxpayers nearly $1 billion dollars.
- Though a significant amount of money when combined, the average Missourian received just $40 in refunds over those five years.
- But, more significant than the refunds was the dynamic that Hancock created. Lawmakers started to believe that Missouri was flush with money and that the state needed to cut taxes in order to avoid the lid. This started a downward slide.

- Between 1993 and 2013 state lawmakers passed 20 different tax cuts which combined cost $1 billion per year.
- Moreover, today Missouri revenue remains about $4 billion under the Hancock lid, and we will likely never hit the lid again.
- As a result, public services and investments in infrastructure have been reduced. In addition, in a lot of cases, responsibility for providing state services has been shifting to localities.

State Rankings:

- Over time the combination of multiple tax cuts has taken a toll. Missouri is now among the lowest in terms of our national rank on nearly every tax and spending indicator.
- Missouri now ranks 47th in the nation in terms of State Revenue Per Capita, collecting just $2,675 per person, well below the national average of $3,669 per person;
- Missouri ranks 43rd in the nation in terms of its State & Local Revenue Per Capita, collecting just $5,304 per person, well below the national average of $6,655
- Spending on state services, as a share of the economy, is now lower than it was 35 years ago.
- Missouri spending on higher education ranks 42nd nationally, and spending on K-12 education ranks 34th.

Tax Credits:

- In addition to the 20 distinct tax reductions that were passed by lawmakers over the last two decades, Missouri now has 60 different tax credit programs.
- Combined the tax credits cost Missouri more than $500 million per year.
- But, there are many different types of credits:
    - Some, like the circuit breaker, help seniors and people with disabilities with fixed incomes remain in their homes,
    - Some benefit non-profit organizations such as domestic violence shelters and those that serve abused kids,
    - Some help to maintain historic buildings and others foster the development of affordable housing.
- Most tax credits were created with good policy intent.
- As a result, there is a not a true “one-size-fits all” solution to reducing the cost of tax credits, or an easy way to balance their cost with funding for public services.
- Instead Missouri can take steps to improve efficiencies in tax credits, reducing their cost while still retaining the community benefits of the credits.
- For example, by simply shifting the Low Income Housing Tax Credit program from a tax credit to a direct grants program, the state could save about 30% of the cost while maintaining the same policy impact.
- Because state taxes are deductible on federal taxes, about 30% of the value that developers receive from the Low Income Housing Tax Credit is eaten up in higher federal taxes.

- In response to this dynamic, several other states have transitioned their low income housing or other tax credits to forgivable loan or grants programs. In order to avoid federal tax consequences, Minnesota transitioned their program to a direct appropriation or grants program, which combines federal Low Income Housing credits with state funds to support the development of low income housing. North Carolina operates a "refundable credit" model, which allows state funds to avoid federal tax consequences.
- Converting to either model would allow Missouri to save at least 30% of the cost of the program, while maintaining the same impact. In 2016, $170 million in Low Income Housing Tax Credits were redeemed. Converting our model to a refundable credit, direct appropriation or forgivable loan program could have saved Missouri $51 million that year alone.

Tax Rates

Missouri gravitates toward the low end compared to other states not only in terms of revenue and spending indicators; but also in terms of tax rates.

Income Tax:

- 42 states rely on the individual income tax to fund essential public services, such as education and public health
- Both the tax rates and the tax brackets can range significantly
- Missouri's individual income tax kicks-in at $1,000 of Missouri taxable income and the highest tax bracket kicks-in at $9,000 of Missouri taxable income
- Missouri's highest tax rate of 6 percent is fairly moderate compared to other states.
    - Of the 42 states and the District of Columbia that have a state income tax, 19 have a higher top tax rate and 19 have a lower top tax rate
    - The highest top tax rate is found in California, at 12.3 percent. Perhaps not surprising. But, Maine, Oregon, Minnesota and Iowa also fall within the top five.
- More significant than the rate is the income level at which state income tax kicks in.
- Missouri's tax brackets were established in 1931 and have not been adjusted since. Because of this we have a very low threshold for both the lowest tax bracket and the top tax bracket.
    - Only 2 states begin taxing residents at a lower income level than Missouri (Alabama and Georgia);
    - Only 3 states have the highest tax bracket kick-in at a lower level of income than Missouri (Alabama, Georgia and Oklahoma);
- In other words, Missouri has a fairly flat income tax, resulting in families living in poverty paying at the same rate as very wealthy individuals
- To put this in context, when the income tax was established, the highest tax bracket of $9,000 would be the equivalent of $146,610 today if adjusted for inflation. The lowest tax bracket would start at $15,846
- In addition, Missouri is one of only 6 states that provide a deduction for federal income tax. This deduction tends to benefit wealthier individuals the most. As a result, families

living in poverty could very well be paying at a higher effective tax rate compared to wealthy families.

Corporate Income Tax:

- Missouri applies corporate income tax as a flat rate of 6.25%
- 31 states have a higher corporate tax rate than Missouri
- Iowa has the highest at 12%; but Iowa also has brackets and applies the top corporate income tax rate only to income of $250,001 and higher.
- Only 11 states apply tax brackets to corporate income tax
- However, Missouri is one of only 4 states that allow a deduction for federal tax paid. As a result, the effective tax rate is lower.

Sales Tax:

- Missouri's state sales tax (including general revenue and earmarked state sales taxes) is 4.225%
- Only 7 states have a lower sales tax rate than Missouri
- 5 states do not have a sales tax
- When state and local sales taxes are combined, the highest rate is in Tennessee which applies 9.45%, well above Missouri's combined state and local sales tax rate of 7.81%

Missouri's outdated tax structure is upside down:

- When all state and local taxes are taken into account, the current tax structure creates a heavier burden the lower your income is.
- Low-wage workers in Missouri who earn less than $53,000 per year pay 9 percent or more of their income in state and local taxes,
- While Missourians earning more than $407,000 per year pay just 5.5 percent of their income in state and local taxes

<u>SOLUTIONS</u>

Because of the way Missouri's tax structure has developed over time, we now have what is largely a hodge-podge of policies that were knee-jerk reactions to short-term dynamics, rather than a thoughtfully constructed tax system that was built to meet the needs of Missourians

In order to assess how to fix the structure, we look toward principles that guide us:

- **Is the tax structure adequate?** By nearly every indicator, it is not. Missouri is not only low compared to other states, but low compared to where we were as a state two decades ago. As a result, we aren't able to invest in the critical public services that serve as the bedrock of our quality of life and provide the foundation upon which families & communities can thrive = such as education, health, public safety and transportation infrastructure
- **Is it fair?** The upside down nature of the tax structure creates a greater burden for low-wage workers than for wealthy Missourians; in addition some of the changes to tax policy over time have resulted in creating "winners and losers" in the economy. We need to level the playing field.

- **Is it Sustainable?** State revenue is at near record lows, compromising our ability to fund services. The current structure is not sustainable.
- But, one thing that Missouri does very well is having a diverse revenue base – with personal income tax, corporate income tax and sales tax creating the three big pillars of our revenue.
- Not placing "all of our eggs in one basket" helps state revenue in terms of stability. The diversity of the revenue structure means that we won't be blindsided by an economic downturn or change in the economy that impacts one area of revenue.
- **Neutrality & Transparency** State tax policy should not pick "winners and losers" in the economy. But, Missouri is increasingly moving in that direction.
- **How does it impact our competitiveness?** Our inability to invest in the services and infrastructure that families, communities and the economy need in order to thrive is reducing our attractiveness as a state.

There is no silver bullet for fixing Missouri's tax structure. It will take a concerted effort over time that includes implementing multiple changes. We can start by plugging holes, revising some of the changes made in recent years, and updating our tax structure. Each of the following changes would help create a more adequate, fair, sustainable, transparent, neutral and competitive tax structure.

<u>Individual Income Tax Reforms</u>

Enact a Missouri Earned Income Tax Credit

- Updating Missouri's income tax brackets to account for more than 80 years can be costly. A bill filed in the state legislature would have updated the brackets so that all income below the poverty line was exempt from income tax. The problem is that this change would have cost more than $1 billion per year, creating even more struggles.
- Instead, Missouri could update the brackets in ways that are "revenue neutral", meaning lifting the thresholds at which the brackets kick in and paying for those changes with either increased rates on higher levels of income or changes to deductions or a combination.
- In the short term, it would be easy and cost effective to instead enact a State Earned Income Tax Credit.
- The federal Earned Income Tax Credit (EITC) has long provided hardworking families the ability to achieve a better future and a pathway to the middle class. The structure of the EITC encourages people to stay working and to work more hours. Though most families receive the EITC only temporarily, it has profound long-term benefits for families and communities.
- Building on the demonstrated success of the federal credit, 26 states and the District of Columbia have created state EITCs that offer a credit towards state and local taxes for low- and moderate-income workers struggling to get by.
- Under a Missouri EITC, 515,000 working families with incomes up to $53,300 per year depending on family size, would receive a modest tax credit.
- The credit would offset the regressivity of state taxes and help to lift families out of poverty.

- A state EITC would put more money in the pockets of people likely to spend it a local businesses to buy groceries or pay for child care or other basics.
- A Missouri EITC would improve the lives of Missouri's children. Research demonstrates that children whose families receive the federal EITC have higher test scores, are more likely to go to college, and enjoy greater earnings as adults, establishing a more productive and skilled workforce for Missouri's future.

Revise the state deduction for federal taxes

- Established in 1972, Missouri provides a state tax deduction for federal taxes paid, which is capped at $5,000 ($10,000 for married).
- We are one of only 6 states that provide this deduction.
- Because federal taxes are progressive, and low-wage families are largely sheltered from federal taxes, they are unlikely to benefit from the state tax deduction.
- In fact, more than half of the benefit of this state tax deduction goes to the top income quintile in the state, the wealthiest 20% of Missourians.
- The deduction costs $509 million per year and contributes to the regressivity of state taxes. If we eliminated the deduction, we could save that money and have only very modest tax increases - the average state tax increase for those in the top income quintile would be just $482-$532 per year
- We could also combine changes to this deduction with a State EITC, equalize the tax structure a bit more and increase revenue for services.

<u>Corporate & Business Income Tax Reforms</u>

Revise corporate tax cuts from 2013/2015

- Revenue from state corporate income tax has dropped by 60% since 2015.
- This decline is largely attributed House Bills 128 (passed in 2013) and Senate Bill 19 (passed in 2015). The bills changed the way multi-state companies calculate their income for state tax purposes.
- The change largely benefited multi-state companies that are housed outside of Missouri, but who profit from the sale of their services and goods to Missourians.
- The change to tax policy is largely recognized by lawmakers as a mistake.
- But, Missouri could easily fix this error by replacing the current corporate income apportionment formula to a simple, single sales factor formula.
- This change would level the playing field between Missouri's bricks-and-mortar businesses and their out-of-state competitors
- 37 states use sales as the basis for apportioning corporate tax for multi-state companies.

Pending Senate Bill 509 (2014) Tax Cuts:

- Unfortunately, Missouri's budget situation is about to get much worse.
- In an effort to "keep up with Kansas", lawmakers passed Senate Bill 509 in 2014, which included several different tax cuts, including some of the same provisions that have created havoc in Kansas.

- The tax cuts are intended to be phased in over a period of years, beginning in 2018.
- When fully implemented they will cost more than $700 million annually.
- The result will be additional cuts to Missouri's already depleted revenue structure.
- The chart projects the impact of SB 509 as it is implemented:
    - The blue line shows the amount of revenue MO needs to meet the K-12 Foundation formula and to maintain the current (FY 2017) budget adjusted for inflation.
    - The red line projects the growth in state revenue under the tax cuts – revenue still grows, but at a slower rate than it otherwise would have.
    - As a result, Missouri will immediately feel the impact of the SB 509 tax cuts; but by 2022 we will face a $538 million budget hole – the hole is based on comparing the growth in state revenue with the implementation of the tax cuts vs. the amount of revenue needed to fully fund K-12 education and maintain the FY 2017 budget with inflation

Repeal the business income deduction in SB 509 (passed in 2014 but not implemented yet)

- Missouri's tax structure is increasingly picking winners and losers in the economy.
- Tax cuts passed in 2014 under Senate Bill 509 would add to that dynamic.
- The tax cuts are scheduled to be implemented in 2018 and include a new "business income deduction" for certain companies that file tax through the individual income tax rather than through corporate tax, including LLCs, S-corporations, Partnerships and Sole Proprietorships.
- Taxes for these businesses would be cut by 25%, while Missouri families and other Missouri businesses would continue to pay tax on the majority of their income.
- As a result, the new exemption creates an incentive for businesses to change their corporate structure in order to avoid paying state tax.
- Tax analysts across the political spectrum agree that this provision simply encourages tax avoidance by giving certain businesses an unfair tax advantage, and it does nothing to stimulate economic growth.
- The Tax Foundation points out that this type of business income exemption unfairly rewards certain businesses simply for the way they are structured, and that "There is no sound economic justification for treating two types of business activity so dramatically differently."
- As the Center on Budget and Policy Priorities has pointed out, the tax exemption would do little to incentivize economic growth because, "A substantial share of the profit exempted from tax…. is earned by wealthy owners of large investment funds and other business entities that have no employees."
- In fact, many of the small businesses that would receive the tax cut under the new exemption are individual contractors or consultants who are also not likely to hire employees. In other words, the exemption will not lead to job growth. Businesses simply do not hire additional employees because they receive a tax cut, they hire when the demand for their services or products increase.

- The same provision wreaked havoc in Kansas. Since the implementation of their tax cuts, budgeting has become completely unpredictable in Kansas; the state has enacted nine rounds of budget cuts, built up record-high levels of debt and had three downgrades in their credit rating.
- Fortunately, Missouri lawmakers can learn from our neighbors and take steps to repeal the business income exemption before it has the same impact here.

Sales Tax Reforms

Enact the Streamlined Sales Tax Collections Mechanism

- Missouri tax laws have failed to keep pace with a changing economy, reducing the state's ability to invest in the well-being of its citizens.
- In particular, Missouri and other states that rely on sales and use taxes to fund public services have been losing revenue as a result of a failure to capture taxes that are owed for online retail purchases through remote sellers. A University of Missouri study estimated that Missouri missed out on $358.3 million in state and local sales tax revenue in 2014.
- In addition to eroding Missouri's ability to invest in critical public services like education, health care and safe roads, the failure to compel remote online retailers to capture sales and use tax also creates a competitive disadvantage for Missouri's bricks-and-mortar retailers who are required to capture sales tax.
- The Streamlined Sales Tax Agreement was developed through the cooperative effort of 44 states, the District of Columbia, local governments and the business community to simplify sales and use tax collection and administration by retailers and states. The intent is to minimize costs and administrative burdens on online and mail-order retailers that collect sales and use tax from customers living in multiple states. It levels the playing field so that local "brick-and-mortar" stores and remote sellers operate under the same rules.
- The legislation helps the states simplify their sales tax laws to make it easier for online retailers to collect and remit state and local sales and use taxes. Once a state has enacted the legislation, it becomes a member of the national Streamlined Sales Tax Governing Board. The Governing Board then notifies all retailers that are registered with the Board that they must begin collecting taxes on purchases made by residents of that state.
- To simplify compliance, the national Streamlined Sales Tax Governing Board has certified seven service providers that interface with the shopping carts of online retailers. Through an automated structure, the service providers are able to calculate appropriate state and local taxes without creating a new burden for online retail companies. The service providers are paid for this service by keeping a small portion of the taxes that they collect.
- Senator Wayne Wallingford (R-District 27) has sponsored legislation in 2016 and 2017 that would enact Streamlined for Missouri.
- Of the 45 states that levy sales tax, 24 states, including many of Missouri's neighbors, have enacted Streamlined, including: Arkansas, Georgia, Indiana, Iowa, Kansas,

Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Caroline, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

Eliminate or revise the Timely Filing Discount

- Although Missouri struggles every year to adequately fund our schools, roads, and other services that provide the foundation for our state's economic growth, it offers some of the most generous tax benefits in the nation to corporations.
- For example, Missouri's "Timely Filing Discount" allows retailers to retain a portion of the sales and use taxes they collect from customers if they remit those taxes to the state in a timely manner.
- This "vendor discount" is the second most generous in the country, and cost Missourians $114 million in 2016.
- Bringing this discount in line with other states would allow our state to make much needed investments in Missourians that would strengthen our quality of life and economic competitiveness.
- Through Missouri's Timely Filing Discount, retailers that remit sales and use taxes in a timely manner are allowed to retain two percent of the taxes collected. The discount was established at a time when companies had to manually calculate and remit sales taxes to state and local governments. However, automation has minimized the amount of time and staffing required for this function, reducing the costs for companies. But while the cost for retailers has decreased, the size of Missouri's vendor discount has not.
- Only 28 of the 45 states and the District of Columbia that have sales taxes provide "vendor discounts," which range from 0.5 percent to five percent of the tax collected.
- Moreover, sixteen of those states have capped the dollar amount retailers can retain, from a low of $50 per month to a high of $10,000 per year.
- In fact, with the exception of only Colorado, all states that have higher vendor discount rates than Missouri either cap the total dollar amount that companies can retain, or apply the higher rate to a limited dollar amount. For example, Georgia provides a three percent vendor discount, but only to the first $3,000 of sales tax collected
- Missouri could update its "timely vendor discount" by capping the total dollar amount that companies can retain.
- **In addition to the vendor discount for retailers, Missouri is the only state that provides a similar timely filing discount to businesses for remitting their payroll taxes on time. This outdated discount cost Missouri an additional $29 million in 2016.**